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BEFORE THE

SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED COMMENTS OF
FARMRAIL SYSTEM, INC.

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Dated: November 17, 2000

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and its subsidiary railroads

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MAJOR RAIL CONSOLIDATION PROCEDURES

VERIFIED COMMENTS OF FARMRAIL SYSTEM, INC.

Farmrail System, Inc. ("FMRS") hereby files these comments to the Notice of Proposed Rulemaking ("NPR") served by the Board on October 3, 2000. FMRS supports the Board's idea of changing the emphasis of its Major Rail Consolidation Procedures from encouraging mergers as a way for carriers to gain efficiencies to requiring merging carriers to preserve and enhance competition. However, FMRS believes that the Board's initiative has fallen short. By relying on applicants to propose how these goals will be accomplished without specific requirements or guidance, the revised regulations virtually guarantee that short lines and the shippers they serve on the fringe of the rail network will continue to be ignored in future merger proceedings. FMRS believes that future mergers should be subject to the "Bill of Rights" proposed by the American Short Line and Regional Railroad Association ("ASLRRA") and by more specific conditions such as those suggested by FMRS and other parties earlier in this proceeding.[1]

[1] FMRS filed Comments (FMRS- 2) and a Reply (FMRS- 3) in connection with the advanced notice of proposed rulemaking ("ANPR") served by the Board on March 31, 2000.

Comments

FMRS is an employee-owned holding company for two Class III common carrier subsidiaries, Farmrail Corporation ("FMRC") and Grainbelt Corporation.("GNBC"). Together they operate approximately 354 miles of contiguous light-density line segments in western Oklahoma. FMRC began operating in 1981 and leases its lines from the State of Oklahoma. GNBC, on the other hand, purchased its rail lines from Burlington Northern Railroad Company ("BN") in 1987. GNBC leases the right-of-way under an agreement with BN that includes "paper barriers" restricting GNBC's ability to handle freight with competitors of BN. Although the traffic base has some diversity, both FMRC and GNBC are heavily dependent on agricultural commodities.[2]

The Board in commencing this proceeding has recognized that the current set of merger procedures is not appropriate for future combinations. FMRS contends that the current policy has led to unforseen massive consolidation, resulting in a railroad industry increasingly focused on long-haul trunk lines to the detriment of the fringe of the network. *See* attached Verified Statement of George C. Betke, Jr. ("Betke V.S."). As is evident from the more than 100 comments filed in response to the ANPR, much of the shipping community, short lines, and general public believe that the Board's rules need to provide additional competitive protections in the event of future mergers.

In setting out its proposed rules, the Board has indicated that it is moving from a pro-merger philosophy (except where there were demonstrable reductions in competition) to one requiring applicants not only to preserve competitive options, but also to provide for some

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[2] A fuller description of FMRC and GNBC, the region they serve, and the history of railroad operations in the region is set forth in FMRS-2.

amount of enhanced competition. Although the broad principles announced by the Board in the NPR and set forth in the proposed regulations are steps in the right direction, a careful reading leaves FMRS with the feeling that short lines will have no better protection under the new rules than they have under the existing ones. Too much is left to the discretion of the applicants, without any specifics for either judging an application or guiding short lines as to what they should expect. The STB fought for the right to reconsider its regulations before considering another merger and was awarded the right to do so. The Board could, and should, have done more with this opportunity.

FMRS is herein selecting certain provisions of the proposed regulations on which to comment, although it believes that other sections would benefit from refinement as well.

Enhanced competition. The cornerstone of the proposed regulations is a requirement that the application provide not only for preserving competition where it currently exists, but also for enhanced competitive options. However, the Board presents nothing specific in this regard. Applicants are left to determine the regions where an accommodation will be offered and the manner in which it will be offered. The minimal opportunities offered short lines in recent mergers leave little doubt that small carriers will fare no better under this scheme.

Based on recent mergers, it is clear that Class I carriers prefer dealing with each while ignoring effects on short lines. CSX Transportation, Inc. ("CSX") and Norfolk Southern Corporation ("NS") agreed on how to carve up Conrail, Inc.; Union Pacific Railroad Company ("UP") granted substantial trackage rights to The Burlington Northern and Santa Fe Railway Company ("BNSF") to get approval to acquire Southern Pacific Railroad Company ("SP"); and BN granted trackage rights to SP to get its merger with The Atchison, Topeka and Santa Fe

Railway Company ("ATSF") approved. As a further example, CSX and NS created shared asset areas in Detroit and northern New Jersey and, with the Board's approval, used the creation of enhanced competition in those areas to defeat requests for similar enhancement in other regions such as Buffalo.

FMRS believes that the final regulations adopted by the Board should provide for imposition of conditions to ensure that short lines and their customers receive due consideration in terms of pro-competitive effects. The regulations should establish a "floor" of enhanced competition, with the applicants being free to provide for more if the circumstances warrant. The ASLRRA "Bill of Rights" presented earlier in this proceeding gives a broad statement of the principles that should be applied, and FMRS presented specific conditions that would provide such relief. *See* FMRS-2.

(a) Competitive pricing. As Western Class I carriers have grown larger and larger through mergers, their pricing has changed to emphasize the longest hauls and to encourage shippers to invest in larger facilities that can handle 100-car unit grain trains. They have talked about eliminating the 26-car units that had been common in Oklahoma. A small minority of country elevators on FMRS can handle even 26-car units at one time, and because of their relatively low volumes and space constraints, expansion is usually not practicable. Even if facilities could be expanded, FMRS's track is not able to handle 100-car trains. FMRS already spends approximately 30% of each revenue dollar on maintaining and improving its infrastructure, and it cannot afford to upgrade lines or loading facilities to accommodate the much larger units. These infrastructure problems will only be exacerbated by the introduction of heavier cars, and the likely loss of traffic if FMRS cannot offer competitive pricing.

Most short lines depend on a preponderance of small shippers that do not handle enough volume or have multiple-plant leverage to secure rate competition. Neither does the short line generate enough business to have any negotiating power with the Class I. Further, because of paper and steel barriers and Class I retention of pricing authority, routing options for short lines that could stimulate competition are often far more limited than the physical rail network would allow. The small railroads need either competitive, nondiscriminatory rates determined on the same basis as nearby Class I stations. *See* FMRS-2.

(b) Elimination of barriers. The elimination or limitation of "paper barriers" that restrict the ability of short lines to provide competitive service would enhance competition to rural shippers served by GNBC. The barriers GNBC agreed to were premised on economics, pricing, traffic and service existing at the time of the sale, all of which have changed. Its connecting carrier, BN, merged with the other dominant Class I serving its region (ATSF). While the resulting merged company, BNSF, has focused on longer hauls and larger trains to become more profitable by lowering unit costs, FMRS can only rely on volume growth. FMRS believes other short-line spinoffs share its experience.

Another restrictive practice that should be discouraged is Class I refusal to allow a short line over which it has ratemaking authority to make a rate for business that is either new or that the Class I cannot reasonably handle with another Class I or with a non-contiguous short line. An awkward situation arises under a competitive block when the blocked carrier calls with a new business opportunity or a competitive rate proposal. The carrier taking the initiative is disadvantaged whether the short line simply advises that the traffic is blocked or refers the inquiry to the blocking carrier so it can attempt to be inserted or to remain in the routing. It doesn't take long before the growth-promoting marketing calls from the "competing" Class I stop coming.

Routing flexibility could also be improved by requiring merging carriers to provide short lines with haulage or trackage rights to nearby interchanges with other Class I carriers. In any new merger, the applicants should be required to rescind all paper and steel barriers. These competition-enhancing conditions would result in additional competitive options for shippers located on short lines and should stimulate both growth in traffic and improved pricing.

3. Essential Services. Almost by definition, short lines cannot afford to lose any traffic as the result of a merger. Current regulations require that for protective conditions to be imposed, a short line must demonstrate that it provides "essential services" and that the services will be lost, *i.e.,* that the company will go out of business. 49 CFR 1180.1(c)(2)(ii). These standards are so high that relief is almost never granted.

The definition of "essential services" has not changed – it still looks at the public need for the service and the transportation alternatives available. However, the Board has increasingly recognized the "vital link" that short lines play in preserving service (NPR at 15), particularly in rural agricultural areas where rail alternatives rarely exist. Without these short lines, the nation's rail system would turn into a further downsized network of trunk lines, accompanied by a dramatic increase in branch-line abandonments. Thus, the regulations should stipulate that short lines provide "essential services."

The STB indicates that its proposed regulations give "increased emphasis to the role of smaller carriers and ports as vital links in the transportation system." NPR at 15. The Board would "consider" whether shifts in traffic patterns undermine the ability of short lines to "sustain" essential services. However, the new regulations do not clarify whether a short line still must demonstrate that it will be forced out of business before it can be entitled to relief.

FMRS believes that, almost by definition, any loss of traffic by a short line will undermine (in the long run, if not immediately) its ability to maintain its lines, upgrade its infrastructure to handle the next generation of cars, and provide reliable competitive service. However, FMRS cannot tell from the proposed regulations whether an expectation of long-term harm would be enough to warrant relief for a short line.

FMRS believes that the Board should clarify the proposed regulations to make it clear that short lines provide "essential services" to the fringes of the rail network. Further, the regulations should provide that any (significant) adverse traffic shifts caused by the merger will undermine the ability of the short line to continue to preserve service and entitle the short line to relief.[3]

4. Service-related losses. The requirement of service assurance plans (proposed §§1180.1(h), 1180.10), including contingency plans, is a step in the right direction toward the goal of minimizing post-merger service disruptions. As is evident from the recent CSX/NS/Conrail transaction, no amount of planning can anticipate all problems, and disruptions almost certainly will occur.

Service delays result in higher costs to shippers and loss of business for short lines when traffic is trucked around them because of choke points on the connecting Class I carriers. The Board's requirement that a "problem resolution team" be established to deal with service problems and "related claims" is not sufficient. In such circumstances, the regulations should require that applicants not only provide a team to address the problems, but also make prompt

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[3] The Board could select a standard such as a 10% loss of traffic, and give parties the opportunity in particular instances to demonstrate that a different level is appropriate.

reimbursement to shippers and connecting short lines for demonstrable service-related losses.

It is also imperative that the Board clearly establish that short lines have claims for lost traffic or additional operating expenses that result from post-merger service-related failures. Short lines serve an important gathering function, and when their connections are not performing normally, there is no way for them to provide satisfactory service to their customers.[4] The Board has recognized that short lines are often in similar positions as shippers and need relief in the same manner. *See CSX/NS/Conrail*, STB Finance Docket No. 33388, Decision No. 89 at 56-57, 72. Certainly with respect to service assurance failures, short lines should be given the same rights to relief and compensation as shippers.

Conclusion

The Board has in various proceedings recognized the vital role that short-line railroads play in preserving rail service options for shippers. However, short lines, typically operating on the fringe of the national network, do not have the same opportunities as Class I carriers to respond to proposed mergers through strategic alliances. Their ability to respond is often further limited by paper barriers imposed, pricing authority retained, and car supply limitations set by the Class I carrier that divested them.

The Board has been presented with a one-time opportunity to change the face of U.S. railroading. But, the regulations as proposed by the Board do not go far enough. Special merger guidelines should be adopted to ensure that the many small carriers and their customers are provided with a minimum amount of enhanced competitive alternatives. This enhanced competition would strengthen the fabric of the entire system and generate more business for all

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[4] This observation is particularly true when there are paper or steel barriers that prevent the short line from handling the traffic with another carrier.

participants. The recommendations set forth by FMRS herein and in its prior comments (FMRS-2) address this opportunity and should be considered by the Board in its determination of the final rules.

Respectfully,

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Dated: November 17, 2000

Attorneys for Farmrail System, Inc.
and its subsidiary railroads

CERTIFICATE OF SERVICE

I hereby certify that on this date a copy of the foregoing Verified Comments of Farmrail System, Inc. was served by First Class Mail, Postage Prepaid, on all Parties of Record.

Dated: November 17, 2000

ERIC M. HOCKY

VERIFIED STATEMENT OF

GEORGE C. BETKE, JR.

George C. Betke, Jr., Chief Executive Officer of Farmrail System, Inc. ("FMRS"), hereby makes the following verified statement in support of the Comments being filed in this proceeding by FMRS:

Two decades after the Staggers Rail Act of 1980 was enacted to enable the nation's railroads to become more competitive, the industry is at another crossroad. The deregulation paradigm is not producing its intended public-interest benefits, either in terms of shipper satisfaction, carrier health, or community well-being.

Reams of testimony were offered in Ex Parte No. 582 by shippers, railroads, public agencies, and other interested parties as to their specific experience and perspective. Those statements can be synthesized into a "big-picture" that should be disheartening to the architects of Staggers.

The Act proved to be a license to discriminate. It has separated rail customers into distinct classes and has split a supposedly seamless, interconnected industry into hostile camps - Eastern and Western mega-railroad duopolies operating 120,000 route miles, and more than 500 largely captive feeder lines responsible for 50,000 miles. It has created an extreme disparity in economic power between the large and the small, whose interline service, competitive rates and car supply are increasingly marginalized by policies and practices of the controlling trunk lines. Because of their lack of bargaining power, nearly 300 small, entrepreneurial carriers formed post-Staggers in the belief that they could revitalize service to the fringe of the system gradually are being disengaged from the core routes, leaving rural America inordinately dependent on a fragile network of arterial highways and secondary roads.

The Interstate Commerce Commission and Surface Transportation Board ("STB" or "Board") have presided over the continued shrinkage of a national treasure - the railroad infrastructure - orchestrated by the major carriers in the name of economic "efficiency." Those carriers are rewarded for judging efficiency solely in the context of their industry. STB's responsibility is to assess efficiency in the context of a balanced national transportation system. The Board's "laissez-faire" approach to regulation not only ignores the counter-productive schism between large and small carriers and adverse competitive effects on smaller shippers, but also disregards critical trade-offs between railroad revitalization and the alternative of massive expenditures for roadway reconstruction.

More and more states are recognizing the inherent value of their remaining rail lines - states like Kansas, Maine, New Hampshire, New York, North Carolina, Oklahoma, Pennsylvania and Vermont that have moved to forestall further disappearance by facilitating major infrastructure investments. Those states are beginning to recognize that preservation of the physical assets must be accompanied by policies that address the mega-railroads' ability to discriminate against use of that infrastructure in terms of service, pricing and car supply. It is not surprising that these issues form the crux of the "Bill of Rights" proposed by the American Short Line and Regional Railroad Association ("ASLRRA"). Because of the extraordinary imbalance of carrier economic power, self help is impossible, and the Board needs to step in to "fix" the problem. If not, Congress or the Department of Justice surely will.

The railroad industry is self-destructing in several ways. Premium service offered in major corridors does not command premium rates, threatening the fundamental concept of differential pricing. Traditional marketing has been ceded to consolidators, freight forwarders, and other intermediaries, leaving the railroads as "wholesale" subcontractors offering little value added. The Class I carriers are indifferent to physical incompatibility of main and branch lines with respect to a new generation of heavier freight cars. Lower unit costs have not inured to the benefit of the carload traffic that accounts for about two-fifths of industry volume. Smaller shippers, lower-rated commodities, and rural communities are being pushed out of the system in the name of efficiency, even as the trucking industry is confronted with its own set of problems - driver shortages, heightened safety enforcement, escalated fuel costs, and greater roadway congestion. The railroads' customer base is narrowing as a result, condemning the industry to a slow-growth future at best.

Most appalling of all the consequences of Staggers, customers continue to be ignored in a railroad culture still dominated by leaders who seem isolated from a faster-moving, marketing-driven society. In theory, a shipper can route a railcar anywhere in the country. In practice, gateway closings, carrier service patterns, line abandonments, tariff restrictions, and discriminatory pricing have reduced flexibility and introduced circuitry and delay into numerous movements while forcing substantial traffic to the highways. In the absence of strict oversight, the carriers have strayed ever farther from their mandated common-carrier obligations, steadfastly disavowing financial responsibility for their service failures.

Inconsistent service and pricing have created uncertainty in customer planning that inhibits long-term investment in rail-related facilities. More and more new industrial parks, manufacturing plants and distribution centers are sited and designed without regard to rail access or with rail as an afterthought. The traffic-building experience of many small railroads, however, accomplished in spite of the industry's over-all service shortcomings, clearly demonstrates the latent growth potential that exists where the serving carrier makes a credible commitment to handling less-than-trainload traffic.

The extraordinary number of shipper complaints aired before the Board speaks for itself. Traditional rail users like R. R. Donnelley and International Paper have shifted major portions of their business to the highways due to lack of reliability. Rail market share of intercity traffic remains stuck at 40% despite unprecedented economic growth, and carload business actually is in decline. Terminal congestion and lack of track capacity due to the removal of double track, sidings, signal installations, and intermediate switching yards have crippled the ability to handle less-than-trainload freight. Repeated down-sizing has reached a stage of dysfunctionality that is apparent to shippers and connecting short lines as things either don't happen or are not done correctly or on a timely basis. Continued friction with labor has been exacerbated by a negative focus on cost-cutting at the expense of volume growth that could maintain and create attractive jobs. The financial community is disillusioned because split-adjusted share prices for the four major U. S. Class I railroads are barely above their levels of 10 years ago. Carrier earnings are unimpressive despite record national economic expansion, and heralded merger savings have proved elusive.

According to the Association of American Railroads ("AAR"), about $260 billion has been invested by Class I carriers to maintain and improve their physical plant and equipment over the past two decades. There is startlingly little to show for it in terms of customer satisfaction, system capacity, market share, public image, employee morale, or stockholder value. This phenomenon did not escape the attention of Jack Welch, Chairman of General Electric, who reportedly chided top executives of the "Big Four" railroads about service deficiencies and customer disaffection at a private meeting last year.

Against this background, and in the face of yet another Class I merger, the STB declared a time-out from mergers so that it could re-examine the procedures that govern major railroad consolidations. After receiving comments from over 100 interested (and mostly frustrated) parties, the Board has determined that it is time for a "paradigm shift" -- it will now require merger applicants to provide evidence of enhanced competition and service assurances. Unfortunately, the admirable platitudes are not followed through in the execution. More disturbing, the STB proposes that the same carrier managements responsible for the dismal record in the past -- poorly conceived merger execution, disregard for outlying communities and small shippers, and insensitivity to the public interest -- will be given the responsibility to propose the blueprint for the 21st century rail network. This proposal gives little credence to the testimony of those shippers, small carriers, public agencies and other observers who commented so extensively. By failing to provide any specific guidelines or minimum competitive requirements, the merger process will be left subject to extraordinary political influence and the result will be starkly uneven. Based on recent merger experience, voluntary competitive protections or enhancements seem possible only between the major carriers with comparable market dominance, leaving small shippers and rural America watching from the sidelines as they become further disadvantaged.

Since the Board seems to believe that two carriers are enough to assure minimal rail-to-rail competition, then why not have two everywhere? Theoretical competition currently limited to selected inter-city corridors and metropolitan markets should at least be extended as far as practicable throughout the system so that rural areas are not further disadvantaged. Even as the AAR decries any movement toward "open access," there is an obvious need to modify a current situation in which genuine duopoly exists in a few areas while the fringe is little more than a collection of "independent" monopolies.

The Board should take this opportunity to protect the public interest that doesn't have the economic power to protect itself, by requiring that enhanced competition be provided to short lines and the fringe of the rail network. In reality, the sheer size of current merger transactions would render pro-competitive concessions granted to short lines inconsequential to the over-all result. (Class III carriers collectively account for less than 10% of industry revenues.)

The Board should also have taken the opportunity to hold merging carriers accountable for the harm caused to short lines by failure of merging carriers to live up to their service promises. While the STB is requiring the formulation of plans and contingency plans, and teams to solve the problems when neither the plans or contingency plans work, it has not recognized that short lines should be entitled to compensation for service-related losses, nor has it required a process requiring prompt payment of such claims.

We applaud the Board's announced change in emphasis from rationalization of physical plant to enhancement of competition, but fear that it comes too late to be effective. Broad pronouncements about enhanced competition are not accompanied by specific guidelines that can give shippers or short lines confidence that their interests would be advanced in any future merger (or that the control premium would not be passed on to customers in the form of higher rates, as has happened after the partitioning of Conrail).

The Board appears to be "passing" on an extraordinary opportunity for real leadership of the warring factions in the railroad industry that could have enormous competitive consequences for years to come. It so far has seemed intent on protecting the status quo in an industry sorely in need of a catharsis while paying inadequate attention to the concerns of the customers that pay the bills.

The U. S. gathering system is undergoing further shrinkage as a relative handful of people determine the scope of an enormously important and irreplaceable public asset - the national railway infrastructure. Can anything be done? Does anyone care? We hope that the Board in its final proposed regulations will show that something can, and that it does.

VERIFICATION

I, George C. Betke, Jr., CEO of Farmrail System, Inc. verify under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file the foregoing.

Executed on November 17, 2000.

George C. Betke, Jr.

George C. Betke, Jr.